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IN THE

Supreme Court of the United States

OCTOBER TERM, 1965.

No. 682

THE OVERLAKES CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

WILLIAM L. HANAWAY,
THOMAS R. MOORE,
Counsel for Petitioner,
1 Chase Manhattan Plaza,
New York, New York 10005.

BREED, ABBOTT & MORGAN,
Of Counsel.

Pandick Press, Inc., 22 Thames St., New York, N. Y. 10006. U. S. A.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1965.

No. .....

THE OVERLAKES CORPORATION,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

TO THE HONORABLE THE CHIEF JUSTICE AND THE ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

Petitioner respectfully asks that a writ of certiorari be issued to review the judgment of the United States Court of Appeals for the Second Circuit affirming the judgment of the Tax Court of the United States.

Opinions Below.

The opinion of the Tax Court is printed in the Appendix to the Brief and Appendix for Petitioner in the Court of Appeals (R.2),* and is reported at 41 T. C. 503 (1964). The opinion of the Court of Appeals is printed in the Appendix hereto (A1), together with its orders denying rehearing (A6), and is reported at 348 F. 2d 462 (2d Cir. 1965).

Statement of Jurisdiction.

The judgment of the Court of Appeals was entered on July 8, 1965, and its orders denying rehearing were entered on August 3, 1965; jurisdiction of this Court is invoked under 28 U. S. C. §1254(1).

Question Presented.

Section 3806 of the Internal Revenue Code of 1939 (Section 1481 of the 1954 Code) provides that, if excessive profits made under a government contract are required to be repaid to the government, the income for "the taxable year" in which such profits were included in income is to be reduced by the amount of such excessive profits, and a credit or refund is to be made to the taxpayer of the taxes paid on such excessive profits.

The question in the instant case is whether the Commissioner can refuse to allocate such reduction in income to "the taxable year" in which the excessive profits were included in income and allocate it instead among all of the

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*The designation "(R.)" refers to the Appendix (containing material parts of the record on review) to the Brief and Appendix for Petitioner in the Court of Appeals and the designation "(A)" refers to the Appendix hereto.

years covered by the contract, including years in which the taxpayer had substantially no taxable income and consequently paid substantially no tax against which such credit or refund could operate, thereby denying to the taxpayer a portion of the relief to which it is entitled under the statute.

Statutory Provision Involved.

The statutory provision involved is Section 3806 of the Internal Revenue Code of 1939, which provides in relevant part:

> "(a) REDUCTION FOR PRIOR TAXABLE YEAR.—
>
> "(1) EXCESSIVE PROFITS ELIMINATED FOR PRIOR TAXABLE YEAR.—In the case of a contract with the United States or any agency thereof, or any subcontract thereunder, which is made by the taxpayer, if a renegotiation is made in respect of such contract or subcontract and an amount of *excessive profits* received or accrued under such contract or subcontract for *a taxable year* (hereinafter referred to as 'prior taxable year') is eliminated and, in a taxable year ending after December 31, 1941, the taxpayer is required to pay or repay to the United States or any agency thereof the amount of *excessive profits eliminated* or the amount of excessive profits eliminated is applied as an offset against other amounts due the taxpayer, the part of the contract or subcontract price which was received or was accrued for *the prior taxable year shall be reduced by the amount of excessive profits eliminated.*
>
> • • • • • •
>
> "(4) EXCEPTION.—The foregoing provisions of this subsection shall not apply in respect of any contract if the taxpayer shows to the satisfaction of the Commissioner that a different method of account-

ing for the amount of the payment, repayment, or disallowance clearly reflects income, and in such case the payment, repayment, or disallowance shall be accounted for with respect to the taxable year provided for under such method, which for the purposes of subsections (b) and (c) shall be considered a prior taxable year.

* * * * * *

"(b) CREDIT AGAINST REPAYMENT ON ACCOUNT OF RENEGOTIATION OR ALLOWANCE.—

"(1) GENERAL RULE.—There shall be credited against the amount of excessive profits eliminated the amount by which the tax for *the prior taxable year* under Chapter 1, Chapter 2A, Chapter 2B, Chapter 2D, and Chapter 2E, is decreased by reason of the application of paragraph (1) of subsection (a); . . ." (Emphasis added.)

Statement of the Case.

The petitioner is a Delaware corporation with its principal place of business in New York City. Petitioner's Federal income tax returns were prepared and its books of account were kept on the calendar year and on the accrual method of accounting (R. 5). In 1951 petitioner entered into a contract with the Signal Corps Procurement Agency whereby petitioner would produce certain wire required for the war effort. Petitioner had never before produced such wire and its initial costs were high, as was anticipated. The contract extended over two taxable years, 1951 and 1952, and by its terms was subject to renegotiation. After completion of the contract, the Army Andit Agency and the Signal Corps Supply Agency, pursuant to such renegotiation provisions, conducted audits of the costs and profits made by petitioner under said contract

and found that petitioner had made a profit in excess of 8.91 percent of its total costs. The agreed upon profit was 8.91 percent of total cost (R. 16). Petitioner agreed to the elimination, by means of a reduction in the *total* contract price, of such excessive profits received under the contract (R. 7, 8, 19, 54-55, 74). From such audits the following facts were developed (R. 56-57, Ex. 12):

	1951	1952
Sales	$2,116,505.83	$2,908,092.99
Costs	1,982,187.01	2,194,646.59
Profit	134,318.82	713,446.40
Allowable Profit (8.91% of Costs)	176,611.45	195,541.59
		517,904.81
	(42,292.63)	(42,292.63)
Amount to be repaid to the government subject to a credit or refund for taxes paid thereon		$ 475,612.18

During 1954 the United States government withheld from monies due petitioner an amount equal to the $475,612.18 of excessive profits that petitioner had included in taxable income for the year 1952, but, contrary to the provisions of Section 3806, the government did not credit or refund to petitioner the taxes paid by petitioner for 1952 on such excessive profits.

Before the Tax Court of the United States the Commissioner admitted that petitioner was entitled to a refund for the taxes paid on such excessive profits. He argued, however, that the Tax Court was not competent to make a determination of the amount to be refunded to petitioner (R. 28-29). The Tax Court rejected this argument. The Commissioner then argued that the excessive profits recap-

tured by the government should be allocated not to 1952, but to 1951 and 1952 on the ratio of gross receipts received by petitioner from the government under the contract during each of those two years. The Commissioner knew that petitioner had substantially no taxable income for 1951 and therefore could derive substantially no benefit from a reduction of its 1951 income. He nevertheless asserted that an allocation between the two years was permissible because the government had recaptured the 1952 excessive profits through the mechanism of a reduction in the total contract price. Because of this mechanism, he argued, the government had not recaptured excessive profits as such but had merely reduced the contract price, even though the government had arrived at the amount of the price reduction only after computing costs and a profit of 8.91 percent thereon; the price reduction was the amount by which profits exceeded such costs and allowable profits. Granting that there had been a reduction in the total contract price, there is no reason why any of the price reduction should be allocated to 1951; all of the price reduction of $475,612.18 should be allocated to 1952, the year in which the excessive profits of $475,612.18 were included in income. The statute contemplates the recapture of excessive profits by the very mechanism of a reduction in the contract price. Thus, Section 3806(a)(1) specifically provides: "the part of the *contract* or subcontract *price* which was received or was accrued for the prior taxable year *shall be reduced* by the amount of excessive profits eliminated." (Emphasis added.)

The Commissioner nevertheless argued that the excessive profits of $475,612.18 included in income for 1952 should be allocated $200,353 to 1951 and $275,259 to 1952 (based on gross contract receipts of $2,116,505.83 in 1951 and $2,908,092.99 in 1952) despite the fact that petitioner's

taxable income for 1951, as shown on its Federal income tax return, was only $29,244.74. The Tax Court, unaware perhaps* of the inequity that would result from the Commissioner's allocation, found that such an allocation was "reasonable" (R. 32). The result was to require petitioner to pay taxes on the very profits which it had been required to repay to the government.

The Court of Appeals for the Second Circuit, perhaps equally unaware of this inequity, affirmed the Tax Court in a per curiam opinion, saying: "We agree with the Tax Court in finding the Commissioner's allocation reasonable" (A3).

Judge Anderson, dissenting, said (A5):

> "By allocating the credit in proportion to the amounts originally accrued in income in each of the years 1951 and 1952, as if it had nothing to do with the taxes in those years, the Commissioner reduced the petitioner's tax credit under §3806 by many thousands of dollars. Although the Commissioner would not allow a taxpayer to spread profits over the two years of the contract to reduce its taxes, he has in this case shifted a substantial portion of petitioner's excessive profits from the year of accrual, 1952, to 1951, in order to reduce the credit available under §3806. *There is nothing to show that Congress ever intended or authorized such treatment, and it is arbitrary and unfair.*
>
> "*McDonnell Aircraft Corp.* v. *United States*, 342 F. 2d 943 (8th Cir. 1965), while distinguishable on the facts, recognized that
>
> "'* * * the statute [§3806] speaks in terms of *the taxable year* and an amount of *excessive profits* "for *a taxable year*"; that the *contract price* for *that year* is reduced by the amount eliminated; and that the

* In another context, the Tax Court opinion states, "This tax credit is not lost to petitioner. . . ." (R. 28).

amount eliminated and repayable is credited with the decrease in tax for *the year*.

'Thus * * * §3806 * * * emphasize [s] *the year* as a unit and give[s] no emphasis to a particular contract or contracts as the measure either of renegotiation, of tax credit or of tax computation' (at p. 948)." (Emphasis added.)

Judge Anderson pointed out that the Commissioner's allocation, between 1951 and 1952, of the prescribed reduction in income, "shifted a substantial portion of petitioner's excessive profits from the year of accrual, 1952, to 1951, in order to reduce the credit available under §3806" (A5). It should be noted in this connection that Section 3806(a)(4) states that the prescribed reduction in income need not be allocated to the year in which the excessive profits were included in income, as is required by Section 3806(a)(1), "if the taxpayer shows to the satisfaction of the Commissioner that a different method [of allocation] clearly reflects income". Thus, even if the Commissioner were otherwise justified in allocating the prescribed reduction in income between 1951 and 1952, rather than to 1952 alone, Section 3806(a)(4) would require that all of such reduction be allocated to 1952 in order clearly to reflect income. The fact that the statute is couched in terms of a showing to the Commissioner's satisfaction does not mean that his decision is final but merely that the proposition is to be proved by the taxpayer. *United States* v. *Jefferson Electric Manufacturing Co.*, 291 U. S. 386 (1934).

Reasons for Allowance of the Writ.

THE DECISION OF THE COURT OF APPEALS IGNORES THE INTENT OF CONGRESS AND THE WORDS OF THE STATUTE.

In enacting Section 3806 of the Internal Revenue Code of 1939 Congress sought to provide relief to taxpayers who were required to repay to the government excessive profits made under government contracts, regardless of the mechanism used to recapture such excessive profits. The section is extensive in its coverage and exclusive in its relief. It provides that where a taxpayer is found to have made excessive profits and is required to repay such excessive profits to the government, the taxpayer is entitled to a credit or refund of the taxes paid on such excessive profits. It provides that there shall be credited or refunded to the taxpayer the amount by which the tax for the taxable year in which the excessive profits were included in income is decreased by the elimination from income of such excessive profits. This elimination from income is accomplished by a reduction of the contract price for such prior taxable year.

In the instant case the Commissioner ignored the taxable year (1952) in which the excessive profits were included in income and argued that it was reasonable to allocate the prescribed reduction in income between the years covered by the contract (1951 and 1952). Generally, no inequity results from such a short cut of the statutory scheme. In the instant case, however, as in any case in which a portion of the prescribed reduction in income is allocated to a year other than that in which the excessive profits were included in income, the relief contemplated by the statute is lost to the extent that the tax paid for that year is less than the credit or refund provided by

Section 3806, since the taxpayer cannot receive a credit or refund in excess of the tax he actually paid for such year. Thus, if a ten-year government contract were to result in no profits and no taxes for nine years, and excessive profits in the tenth year, the Commissioner's short cut would give the taxpayer only 10 percent of the relief to which he is entitled, assuming that payments under the contract were received ratably over the ten-year period.* Congress never intended or authorized such treatment, and it would be arbitrary and unfair, as is the treatment accorded petitioner in the instant case.

THE IMPORTANCE OF THE QUESTION PRESENTED.

There are three compelling reasons why this Court should grant certiorari in the instant case. First, there is the conflict between the decision of the Court of Appeals for the Second Circuit in the instant case and that of the Court of Appeals for the Eighth Circuit in *McDonnell Aircraft Corp.* v. *United States,* 342 F. 2d 943 (8th Cir. 1965). Second, there is the public interest in, and economic importance of, a question involving the integrity of the renegotiation process: in fiscal 1964 alone, the Renegotiation Board screened filings of $39.3 billion of renegotiable sales, up from $31.2 billion in fiscal 1963, many of the filings and settlements being voluntary. *The Renegotiation Board Ninth Annual Report 1964,* at 7, 4 and 1. Third, there is the inequity and the severe economic dislocation to the taxpayer that would result from the Commissioner's arbitrary allocation of the renegotiated excessive profits.

* Indeed, under the Commissioner's approach, it would seem that the government could go one step further and deny even such partial relief—thus completely gutting Section 3806—by first recapturing the excessive profits made in the tenth year and by then allocating all of the price reduction to the first nine years and none to the tenth year.

1. The instant case is in direct conflict with *McDonnell Aircraft Corp.* v. *United States,* 342 F. 2d 943 (8th Cir. 1965), in that there the court rejected the very argument by the government that here prevailed. The *McDonnell* case held that excessive profits eliminated by renegotiation were allocable in their entirety to reduce the income of the taxable year in which they were included in income and that they were not to be allocated, as contended by the government, "on a sales proration basis" among the taxable years during which the contracts were performed, 342 F. 2d at 946. The court declared:

> "Section 3806 . . . speaks in terms of the taxable year and an amount of excessive profits 'for a taxable year'; that the contract price for that year is reduced by the amount eliminated; and that the amount eliminated and repayable is credited with the decrease in tax for the year.
>
> "Thus the 1951 Renegotiation Act and §3806 of the 1939 Code and, for that matter, the 1948 Renegotiation Act, all emphasize the year as a unit and give no emphasis to a particular contract or contracts as the measure either of renegotiation, of tax credit or of tax computation." 342 F. 2d at 948.

2. The inequitable result reached below undermines the whole relief structure provided by Section 3806 of the Internal Revenue Code of 1939 and continued by Section 1481 of the 1954 Code. It endangers also the entire renegotiation process contemplated by Congress. Renegotiation of excessive profits plays a vital role in the nation's economy, and in its pursuit of justice and fairness. As stated in *The Renegotiation Board Ninth Annual Report 1964,* at 1:

> "Determinations of excessive profits during fiscal year 1964 aggregated $24,160,028, bringing the total

since 1951 to *$895,795,058*, before adjustment for Federal income and excess profits tax credits. *The policy embodied in the Renegotiation Act is also furthered by voluntary actions of defense contractors.* In fiscal 1964, *voluntary refunds and price reductions*, reported in connection with renegotiation proceedings, amounted to $41,097,044. Such reported savings *totaled $1,230,151,174* since the creation of the present Board. Thus, the purpose of the Renegotiation Act as defined by Congress—the elimination of excessive profits on Government contracts and related subcontracts—is accomplished *both* by Board proceedings resulting in refunds of excessive profits *and by the voluntary actions of contractors.*" (Emphasis added.)

As also stated in Judge Anderson's dissent (A5-A6):

"For the majority here to hold that there is not a renegotiation to determine *excessive profits* . . . whenever the parties have engaged in a discussion and determination of 'total price, including "cost and profit factors"' instead of just profits, injects unnecessary complexities and distinctions into the application of §3806 and brings about *the unfair result which is manifest here.* In addition, *contrary to accepted policy*, it penalizes any contractor who sits down and discusses the factors involved, including cost and profit, and reaches an amicable agreement with the Government agency. It is also somewhat unclear just how the contracting parties can ever renegotiate for a determination of *excessive profits* without considering or discussing 'total price' and 'cost * * * factors.' *But hereafter the taxpayer will do so at his peril.*" (Emphasis added.)

3. The inequitable result reached below would require petitioner to pay taxes on the very profits it has repaid

to the government. Because of the substantial sum involved, denial of the relief provided by Section 3806 would severely cripple the taxpayer as a viable business enterprise.

Conclusion.

Under the circumstances, the obvious importance of the question presented clearly calls for an exercise of this Court's power of review.

Respectfully submitted,

WILLIAM L. HANAWAY,
THOMAS R. MOORE,
Counsel for Petitioner,
1 Chase Manhattan Plaza,
New York, New York 10005.

BREED, ABBOTT & MORGAN,
Of Counsel.

Opinion.

UNITED STATES COURT OF APPEALS,

SECOND CIRCUIT.

Argued April 20, 1965.

Decided July 8, 1965.

THE OVERLAKES CORPORATION,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

No. 339, Docket 29378.

Proceeding on petition for review of a decision of the Tax Court of the United States, 41 T. C. 503. The Court of Appeals held that under government contract providing for redetermination of price because of the great uncertainty as to the cost of performance, commissioner's allocation of the amount to be refunded by taxpayer between the taxable years in proportion to the amounts originally accrued as income in those years was reasonable.

Affirmed.

Anderson, Circuit Judge, dissented.

Internal Revenue 281

Under government contract providing for redetermination of price because of great uncertainty as to cost of performance, contract price redetermination constituted a redetermination of total price, including cost and profit factors rather than profits alone, and commissioner's allo-

cation of amount refunded by taxpayer between taxable years in proportion to amounts originally accrued as income in those years was reasonable. 26 U. S. C. A. (I. R. C. 1939) §3806 and (c).

ELDEN MCFARLAND, of MCFARLAND, JACOBS, BARRY & LATCHFORD, Washington, D. C. (EDWIN A. TENNANT, JR., WAGNER, QUILLINAN & TENNANT, New York City, of counsel), for petitioner.

LORING W. POST, Attorney, Department of Justice, Washington, D. C. (LOUIS F. OBERDORFER, Asst. Atty. Gen., LEE A. JACKSON, HARRY BAUM, Attorneys, Department of Justice, Washington, D. C., on the brief), for respondent.

Before KAUFMAN, HAYS and ANDERSON, Circuit Judges.

PER CURIAM:

We affirm the decision of the Tax Court. 41 T. C. 503 (1964). The facts of the case are fully set forth in the Tax Court's opinion. The petitioner entered into a defense contract in 1951 with the Army Signal Corps Procurement Agency to supply a number of reels of wire as required. The contract contained a provision for redetermination of price "because of the experimental and developmental nature of the work * * * and the great uncertainty as to the cost of performance." Since petitioner used the accrual method of accounting, the amounts for which it billed the contracting agency during 1951 and 1952 were accrued as income for each of those years. In 1954 the petitioner and the contracting agency, after a study of "cost and profit factors," agreed upon a contract price redetermination which resulted in a refund of $475,612.17 by the petitioner to the contracting agency which was accomplished by offsetting the refund against amounts owed the petitioner. The Tax Court held that the petitioner, having reported as

income during 1951 and 1952 the $475,612.17 which it refunded in 1954, is entitled under Section 3806(c) of the Internal Revenue Code of 1939[1] to a credit for overpayment of taxes for each of those prior taxable years. The only issue here is the method of allocating the $475,612.17 refund between the taxable years 1951 and 1952. The Tax Court upheld as reasonable the Commissioner's method of allocation "in proportion to the amounts originally accrued in income in those years." 41 T. C. at 519-520.

We agree with the Tax Court in finding the Commission's allocation reasonable. As provided in the contract and in the price modification agreement, what was being redetermined was the total price, including "cost and profit factors," rather than profits alone as contended by the petitioner.[2]

Affirmed.

ANDERSON, Circuit Judge (dissenting):

The majority seems completely bemused by the words "contract price redetermination" which they treat as something quite distinct from and wholly unconnected with a finding of excessive profits. They accept the Commission-

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[1] Added by ch. 619, 56 Stat. 966 (1942).

[2] Subsequent to oral argument the Commissioner informed the court and counsel for petitioner of the decision of the Eighth Circuit in *McDonnell Aircraft Corp.* v. *United States*, 342 F. 2d 943 (1965). That case concerned "the usual complicated fact situation attendant upon an excess profits tax case * * * [which was] triggered by [the taxpayer's] statutorily permitted change of accounting for its long-term contract income." Id. at 946. Also involved in the case was the interpretation of the Renegotiation Acts of 1948 and 1951, as well as §3806 of the Internal Revenue Code of 1939. The instant case is distinguishable because (1) the contractual price redetermination herein was not brought about by renegotiation of "excessive profits" under the Renegotiation Acts as in *McDonnell*, and (2) the petitioner herein has not obtained permission for a change of its accounting method as was done by the taxpayer in *McDonnell*. We also note that the Eighth Circuit itself distinguished the instant case. Id. at 950.

er's thesis that the parties to the contract made an across the board reduction in unit sales prices and, on evidence which is dubious at best, the Tax Court so found.* But whatever the post-performance negotiations and agreement may be called, it was a renegotiation to determine excessive profits as defined in §3806(a) (1) (A). The so-called contract price redetermination was not an end in itself but was a means of determining such excessive profit. Any profit over what was normally allowable, here 8.91%, was agreed to be excessive profit. For the purpose of taxation all of the profit was subject to income tax *for the year in which the profit was made.* The taxes were paid on that basis for each of the years of the contract, 1951 and 1952. There were no profits in excess of 8.91% in 1951, and therefore no income tax was paid on any excess profits in that year; but there were excessive profits in 1952 in the amount of $475,612.17, which was a part of the income taxed for 1952. As soon as the excessive profit in 1952 was determined, §3806(c) became operative. Calling it an "overpayment" simply describes a means of crediting the tax refund due and in no way alters the fact that it resulted from a renegotiation for determination of excessive profits and the repayment of the same. The purpose of §3806 is to give petitioner a credit equal to the taxes paid on the excessive profits it refunded to the Government.

> "Section 3806 of the Internal Revenue Code provides, in general, that the amount of excessive profits to be eliminated shall be credited by the amount of Federal income and excess profits taxes paid with respect to such excessive profits." U. S. Code Cong. and Admin. News Service, 1951, p. 1362.

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* In fact, the Tax Court found that there was not an across the board reduction in unit sales prices but a reduction in the *total* contract price (R. 7, 8, 19, 54-55, 74), as did the majority opinion *supra.* [Footnote by petitioner.]

Opinion.

By allocating the credit in proportion to the amounts originally accrued in income in each of the years 1951 and 1952, as if it had nothing to do with the taxes in those years, the Commissioner reduced the petitioner's tax credit under §3806 by many thousands of dollars. Although the Commissioner would not allow a taxpayer to spread profits over the two years of the contract to reduce its taxes, he has in this case shifted a substantial portion of petitioner's excessive profits from the year of accrual, 1952, to 1951, in order to reduce the credit available under §3806. There is nothing to show that Congress ever intended or authorized such treatment, and it is arbitrary and unfair.

McDonnell Aircraft Corp. v. *United States*, 342 F. 2d 943 (8th Cir. 1965), while distinguishable on the facts, recognized that

> "'* * * the statute [§3806] speaks in terms of the taxable year and an amount of excessive profits 'for a taxable year'; that the contract price for that year is reduced by the amount eliminated; and that the amount eliminated and repayable is credited with the decrease in tax for the year.
>
> "Thus * * * §3806 * * * emphasize[s] the year as a unit and give[s] no emphasis to a particular contract or contracts as the measure either of renegotiation, of tax credit or of tax computation" (at p. 948).

The *McDonnell* case's interpretation and application of §3806 is, in that regard, authority for this case. For the majority here to hold that there is not a renegotiation to determine excessive profits, as "renegotiation" is defined in §3806(a) (1) (A), whenever the parties have engaged in a discussion and determination of "total price, including 'cost and profit factors'" instead of just profits, injects unnecessary complexities and distinctions into the application of §3806 and brings about the unfair result

which is manifest here. In addition, contrary to accepted policy, it penalizes any contractor who sits down and discusses the factors involved, including cost and profit, and reaches an amicable agreement with the Government agency. It is also somewhat unclear just how the contracting parties can ever renegotiate for a determination of excessive profits without considering or discussing "total price" and "cost * * * factors." But hereafter the taxpayer will do so at his peril.

Orders Denying Rehearing.

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT.

THE OVERLAKES CORPORATION,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for Rehearing.

ELDEN MCFARLAND, Washington, D. C., for petitioner.

Motion for rehearing denied.

I. R. K.
P. R. H.
U.S.C.JJ.

I dissent.

R. P. A.
U.S.C.J.

3 August 1965.

Orders Denying Rehearing.

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT.

THE OVERLAKES CORPORATION,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for Rehearing in Banc.

ELDEN MCFARLAND, Washington, D. C., for petitioner.

No active circuit judge having requested that the case be reheard in banc, the petition is denied.

s/ J. EDWARD LUMBARD

Chief Judge.

3 August 1965.

In the Supreme Court of the United States

OCTOBER TERM, 1965

No. 682

THE OVERLAKES CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 2–34)[1] are reported at 41 T.C. 503. The majority and dissenting opinions of the court of appeals (Pet. A1–A6) are reported at 348 F. 2d 462.

JURISDICTION

The judgment of the Court of Appeals was entered on July 8, 1965 (Pet. 2). The petition for rehearing *en banc* was denied on August 3, 1965 (Pet. A7). The petition for a writ of certiorari was filed on Octo-

[1] Record references are to the appendix to the taxpayer's brief in the court of appeals.

794-487—65

ber 20, 1965. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

The taxpayer sold wire to the government in 1951 and 1952 under a defense contract, and accrued the total contract price as income on the basis of shipments in those years. The contract was subject, however, to revision of the price, and the price was, in fact, later revised downward and a refund made by the taxpayer to the government. The question presented is whether, for purposes of computing the tax credit to which the taxpayer is entitled under Section 3806 of the Internal Revenue Code of 1939, it was reasonable to allocate the refund between 1951 and 1952 on the same basis that the original contract price had been accrued as income in those years.

STATUTE INVOLVED

The pertinent provisions of Section 3806 of the Internal Revenue Code of 1939 are set out in the Appendix, *infra*, pp. 7–8.

STATEMENT

The pertinent facts as found by the Tax Court (R. 5–21) may be summarized as follows:

On January 17, 1951, the taxpayer entered into a contract for the sale of wire to the government. The contract contained a price revision clause providing that because of the experimental and developmental nature of the work called for by the contract, and the great uncertainty as to the cost of performance, the

parties, after completion of the contract, would negotiate to agree upon a reasonable revised price for the entire contract; and such revised price might be more or less than the price originally fixed (R. 5–6).

The taxpayer received, for deliveries of wire under the contract, a total consideration of $5,024,598[2] based on the estimated price, and accrued this amount on the basis of miles shipped, resulting in income of $2,116,505 in 1951 and $2,908,093 in 1952. After completion of the contract, the parties agreed upon a redetermined contract price of $4,548,986, and the taxpayer accordingly refunded $475,612 to the government in 1954, representing the difference between the total consideration of $5,024,598 received by the taxpayer and the revised price of $4,548,986 (R. 9–19).

In computing the taxpayer's tax credit under Section 3806 of the 1939 Code, the Internal Revenue Service determined that the amount of the refund ($475,612) should be allocated between the years 1951 and 1952 in proportion to the amounts originally accrued as income in those years (R. 9, 30). This resulted in an allocation of $200,353 to 1951 and $275,259 to 1952.

The Tax Court unanimously sustained this allocation (R. 32). The taxpayer appealed, contending that the entire $475,612 represented excessive profits which had been earned in 1952 and which should therefore be subtracted from its income for that year, producing a greater Section 3806 credit than allowed by the Tax Court for 1952. The court of appeals affirmed *per curiam*, one judge dissenting (Pet. Ad. A6).

[2] Round dollar amounts are used for convenience.

The taxpayer's petition for rehearing *en banc* was denied (Pet. A7).

ARGUMENT

1. Section 3806(a)(1) of the 1939 Code provides, in essence, that where as a result of renegotiation the taxpayer is compelled to refund as excessive profits a portion of the original contract price, the excessive profits eliminated shall be subtracted from the part of the contract price originally received or accrued for the prior taxable year; and a tax credit shall be allowable accordingly for the prior year. The single question presented is whether it was proper to allocate the amount the taxpayer here was required to refund on the same basis as it had originally accrued the income under the contract over 1951 and 1952. We submit that it clearly was. The price reduction that the parties agreed upon was a revision of the entire contract price for goods shipped in 1951 and 1952; the effect of the renegotiation was to substitute a new price for the price in the original contract. Cf. *Wener* v. *Commissioner*, 24 T.C. 529, 532, affirmed, 242 F. 2d 938 (C.A. 9). Since the original contract price had been accrued over both years, it was logical to allocate the revised price between the two years on the same basis, rather than bunch the entire refund in the second year. The taxpayer's attempt to show that the refund in fact represented excessive profits earned in 1952, and not in 1951, is inconsistent with the accrual method of accounting it employed, whereby its income under the contract was spread between the two years on the basis of shipments; and with the terms of the renegotiation agree-

ment, which involved a revision of the entire contract price rather than a redetermination of profits as such.

2. There is no conflict between the decision below and that of the Eighth Circuit in *McDonnell Aircraft Corp.* v. *United States*, 342 F. 2d 943, as the court below (Pet. A3) and the court in *McDonnell* (342 F. 2d at 950) both recognized. The basis of the holding in *McDonnell* that the renegotiation refund was attributable in its entirety to a single year was that there the refund was the result of a full-fledged renegotiation proceeding conducted on the basis of a particular taxable year involving many contracts, not, as here, on the basis of a particular contract. "Under the statute, renegotiation is conducted not with respect to individual contracts, but with respect to the receipts or accruals of a contractor under all renegotiable contracts and subcontracts in a fiscal year of the contractor." *The Renegotiation Board Ninth Annual Report 1964*, p. 2. Where the refund is on the basis of the year, not the contract, there is no basis for an allocation of the refund to other years. But where, as in the present case, there is no full-fledged renegotiation proceeding, but simply a price redetermination respecting a particular contract, the principle of the *McDonnell* case obviously does not require lumping the entire refund in a single year. The renegotiation here was in respect to a contract, not a year.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the petition for a writ of certiorari should be denied.

RALPH S. SPRITZER,
*Acting Solicitor General.**

RICHARD M. ROBERTS,
Acting Assistant Attorney General.

HARRY BAUM,
LORING W. POST,
Attorneys.

NOVEMBER 1965.

*The Solicitor General having disqualified himself.

APPENDIX

Internal Revenue Code of 1939:

SEC. 3806. MITIGATION OF EFFECT OF RENEGOTIATION OF WAR CONTRACTS OR DISALLOWANCE OF REIMBURSEMENT.

(a) *Reduction for Prior Taxable Year.*—

(1) *Excessive profits eliminated for prior taxable year.*—In the case of a contract with the United States or any agency thereof, or any subcontract thereunder, which is made by the taxpayer, if a renegotiation is made in respect of such contract or subcontract and an amount of excessive profits received or accrued under such contract or subcontract for a taxable year (hereinafter referred to as "prior taxable year") is eliminated and, in a taxable year ending after December 31, 1941, the taxpayer is required to pay or repay to the United States or any agency thereof the amount of excessive profits eliminated or the amount of excessive profits eliminated is applied as an offset against other amounts due the taxpayer, the part of the contract or subcontract price which was received or was accrued for the prior taxable year shall be reduced by the amount of excessive profits eliminated. For the purposes of this section—

*** * (A) The term "renegotiation" includes any transaction which is a renegotiation within the meaning of the Federal renegotiation act applicable to such transaction, any modification of one or more contracts with the United States or any agency thereof,**

and any agreement with the United States or any agency thereof in respect of one or more such contracts or subcontracts thereunder.

(B) The term "excessive profits" includes any amount which constitutes excessive profits within the meaning assigned to such term by the applicable Federal renegotiation act, any part of the contract price of a contract with the United States or any agency thereof, any part of the subcontract price of a subcontract under such a contract, and any profits derived from one or more such contracts or subcontracts.

* * * * *

(b) *Credit Against Repayment on Account of Renegotiation or Allowance.*—

(1) *General rule.*—There shall be credited against the amount of excessive profits eliminated the amount by which the tax for the prior taxable year under Chapter 1, Chapter 2A, Chapter 2B, Chapter 2D, and Chapter 2E, is decreased by reason of the application of paragraph (1) of subsection (a); and there shall be credited against the amount disallowed the amount by which the tax for the prior taxable year under Chapter 1, Chapter 2A, Chapter 2B, Chapter 2D, and Chapter 2E, is decreased by reason of the application of paragraph (2) and subsection (a).

* * * * *

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1965.

THE OVERLAKES CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

REPLY BRIEF FOR THE PETITIONER.

WILLIAM L. HANAWAY,
THOMAS R. MOORE,
Counsel for Petitioner,
1 Chase Manhattan Plaza,
New York, New York 10005.

BREED, ABBOTT & MORGAN,
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Statement of the Case.

A full statement of the case is set forth in the Petition For a Writ of Certiorari on pages 4 through 8.

Argument.

The Brief For The Respondent In Opposition to the Petition For A Writ Of Certiorari makes two points, and is in error with respect to both of them.

1. Petitioner reported its receipts, expenses and net income for the two years in question, 1951 and 1952, on the accrual method of accounting (Pet. 4). Petitioner in 1951

accrued sales of $2,116,505, costs of $1,982,187 and profits (net income) of $134,318; it was later found to have had no excessive profits in 1951 (Pet. 5). The government nevertheless contends that it would be "inconsistent with the accrual method of accounting" to allocate to 1951 none of the excessive profits accrued and included in income in 1952 and later repaid to the government (Resp. Brief 4). The government's contention is clearly unsound: the accrual method of accounting requires that both receipts *and* expenses be reported on the accrual method. The government ignores this obvious fact and attempts to allocate the recaptured excessive profits on the basis of sales made in each of the years. By thus ignoring petitioner's expenses, the government seeks to allocate $200,353 of the recaptured excessive profits to 1951, although in 1951 petitioner had no excessive profits and had only $134,318 of net income under the contract (Pet. 6). In a case of such importance to petitioner and to all governmental contractors, these facts cannot be ignored.

2. The instant case is in direct conflict with *McDonnell Aircraft Corp.* v. *United States,* 342 F. 2d 943 (8th Cir. 1965) (Pet. 11). There the Court held that recaptured excessive profits should be allocated to 1951, the year in which the taxpayer had included such profits in net income. The government contended in *McDonnell* that the recaptured excessive profits should be allocated over a three year period, 1949-1951, on the basis of sales made during each of those years, even though no amount had been included in taxpayer's net income for the years 1949 and 1950.

The government here attempts to distinguish the instant case from the *McDonnell* case on the dual grounds that "there the refund was the result of a full-fledged renegotia-

tion proceeding" involving "many contracts, not, as here, on the basis of a particular contract" (Resp. Brief 5). As to the first ground, the Renegotiation Board has said, ". . . the purpose of the Renegotiation Act as defined by Congress . . . is accomplished both by Board proceedings resulting in refunds of excessive profits and by voluntary actions of contractors." (Pet. 12). Voluntary settlements are to be encouraged. As to the second ground, whether one or many contracts are involved in a renegotiation is palpably immaterial. The statute and the cases afford no support for so distinguishing *McDonnell* from the instant case.

Conclusion.

For the reasons set forth in the Petition For A Writ Of Certiorari, especially in light of the conflict between the circuits discussed herein, the question presented clearly calls for an exercise of this Court's power of review.

Respectfully submitted,

WILLIAM L. HANAWAY,
THOMAS R. MOORE,
Counsel for Petitioner,
1 Chase Manhattan Plaza,
New York, New York 10005.

BREED, ABBOTT & MORGAN,
Of Counsel.